

IT 96-13

Tax Type: INCOME TAX

Issue: 1005 Penalty (Reasonable Cause Issue)
Business/Non-Business (General)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE)		
OF THE STATE OF ILLINOIS,)	
)	
Petitioner)	No.
)	
v.)	FEIN:
)	
TAXPAYER,)	
Taxpayer)	Linda K. Cliffel,
)	Admin. Law Judge

RECOMMENDATION FOR DISPOSITION

SYNOPSIS:

TAXPAYER ("TAXPAYER" OR "TAXPAYER") IS A MARYLAND CORPORATION WHICH FILES A UNITARY RETURN WITH ITS WHOLLY-OWNED SUBSIDIARY, SUBSIDIARY CERTAIN INTEREST FROM FEDERALLY TAX-EXEMPT BONDS WAS CHARACTERIZED BY THE TAXPAYER AS NONBUSINESS INCOME, AND ALLOCATED OUTSIDE OF ILLINOIS. TAXPAYER MAINTAINS THAT THE INVESTMENTS GIVING RISE TO THE INTEREST WERE NOT AN INTEGRAL PART OF THEIR TRADE OR BUSINESS, NOT USED AS WORKING CAPITAL AND TAXPAYER EMPLOYEES DID NOT MANAGE THE INVESTMENTS.

ON JANUARY 22, 1993, THE DEPARTMENT OF REVENUE ISSUED A NOTICE OF DEFICIENCY FOR THE TAX YEAR ENDED NOVEMBER 30, 1989 IN THE AMOUNT OF \$15,478 INCLUDING SECTION 1001 AND 1005 PENALTIES.

THIS MATTER COMES TO HEARING PURSUANT TO THE TAXPAYER'S TIMELY PROTEST DATED FEBRUARY 1, 1993. THE ISSUES TO BE DECIDED ARE WHETHER THE DEPARTMENT PROPERLY RECLASSIFIED THE INTEREST FROM TAXPAYER'S TAX-EXEMPT SECURITIES AS BUSINESS INCOME, AND WHETHER THE SECTION 1005 PENALTY WAS PROPERLY IMPOSED. TAXPAYER DID NOT SPECIFICALLY PROTEST THE IMPOSITION OF THE LATE FILING PENALTY UNDER SECTION 1001, NOR HAS THE TAXPAYER PRESENTED ANY EVIDENCE TO SHOW THAT THE RETURN WAS TIMELY FILED.

TAXPAYER WAIVED ITS RIGHT TO A HEARING AND REQUESTED THAT A DECISION BE MADE ON THE BASIS OF THE DOCUMENTS PRESENTED. ON CONSIDERATION OF THESE MATTERS, IT IS RECOMMENDED THAT THESE ISSUES BE RESOLVED IN FAVOR OF THE DEPARTMENT.

FINDINGS OF FACT:

1. TAXPAYER IS A MARYLAND CORPORATION DOING BUSINESS IN ILLINOIS. (IL-1120 FOR THE TAX YEAR ENDED NOV. 30, 1989).

2. TAXPAYER IS IN THE TRADE OR BUSINESS OF MANUFACTURING AND DISTRIBUTING COSMETICS, TOILETRIES AND HOUSEHOLD PRODUCTS. (TAXPAYER'S PROTEST).

3. TAXPAYER'S COMMERCIAL DOMICILE IS OUTSIDE ILLINOIS. (TAXPAYER'S PROTEST).

4. TAXPAYER FILED AN ILLINOIS COMBINED INCOME TAX RETURN WITH ITS WHOLLY-OWNED SUBSIDIARY, SUBSIDIARY (IL- 1120 FOR THE TAX YEAR ENDED NOV. 30, 1989).

5. DURING 1989 TAXPAYER HAD TAX-EXEMPT INVESTMENTS WHICH RANGED FROM A HIGH OF \$107,967,130 TO A LOW OF \$15,545,034. (TAXPAYER'S LETTER DATED OCT. 7, 1993, EX. 1).

6. ON ITS 1989 ILLINOIS INCOME TAX RETURN, TAXPAYER CLAIMED THE INTEREST EARNED ON ITS TAX-EXEMPT INVESTMENTS, IN THE AMOUNT OF \$3,533,748, WAS NONBUSINESS INCOME. (IL-1040 FOR THE TAX YEAR ENDED NOVEMBER 30, 1989; NOTICE OF DEFICIENCY).

7. THE INTEREST AT ISSUE WAS EARNED THROUGH INVESTMENTS IN SIX ACCOUNTS OF TAXPAYER: ACCOUNT #1; ACCOUNT #2; ACCOUNT #3; ACCOUNT #4; ACCOUNT #5; AND ACCOUNT #6. (TAXPAYER'S LETTER DATED OCT. 7, 1993, EX. 1 AND 1A).

8. ACCOUNT #1, HAD A ZERO BALANCE UNTIL JULY 31, 1989. MONTHLY ENDING BALANCES FOR THE FOUR-MONTH PERIOD OF JULY 31 TO NOVEMBER 30, 1989 RANGED FROM \$2,551,632 TO \$14,136,288. (TAXPAYER'S LETTER DATED OCT. 7, 1993, EX. 1 AND 1A).

9. ACCOUNT #2, HAD BALANCES AT MONTH END RANGING FROM \$43,262,980 TO \$19,995,313, FROM JANUARY 31 TO JUNE 30, 1989. ON JULY 31, 1989, \$9,976,296 WAS TRANSFERRED TO CORPORATION (SEE FINDING #14). (TAXPAYER'S LETTER DATED OCT. 7, 1993, EX. 1 AND 1A).

10. ACCOUNT #3, HAD MONTHLY BALANCES RANGING FROM \$43,820 TO \$11,626,915. (TAXPAYER'S LETTER DATED OCT. 7, 1993, EX. 1 AND 1A).

11. ACCOUNT #4, REMAINED FAIRLY CONSTANT AT BETWEEN \$76,720 AND \$80,593. THE INCREASE IN THE ACCOUNT WAS DUE TO THE ACCUMULATION OF INTEREST OF APPROXIMATELY \$400 PER MONTH. (TAXPAYER'S LETTER DATED OCT. 7, 1993, EX. 1 AND 1A).

12. ACCOUNT #5, HAD MONTHLY BALANCES RANGING FROM \$64,547,310 TO \$45,621,076 FROM JANUARY 31 TO JUNE 30, 1989. ON JULY 31, 1989, \$40,252,429 WAS TRANSFERRED TO CORPORATION (SEE FINDING #14). (TAXPAYER'S LETTER DATED OCT. 7, 1993, EX. 1 AND 1A).

13. ACCOUNT #6, HAD A MONTHLY ENDING BALANCE OF \$981,563 FOR EACH MONTH FROM JANUARY 31 TO JUNE 30, 1989. (TAXPAYER'S LETTER DATED OCT. 7, 1993, EX. 1 AND 1A).

14. ON JUNE 19, 1989, TAXPAYER FORMED CORPORATION ("CORPORATION"), A DELAWARE CORPORATION, AS ITS WHOLLY-OWNED SUBSIDIARY TO MANAGE ITS INVESTMENTS. THE INITIAL CAPITALIZATION OF CORPORATION WAS \$75 MILLION: \$64 MILLION WAS TRANSFERRED TO CORPORATION IN JULY, 1989 WITH AN ADDITIONAL \$10,636,000 BEING TRANSFERRED TO CORPORATION IN SEPTEMBER, 1989 WHEN CERTAIN SHORT-TERM SECURITIES MATURED. (TAXPAYER'S LETTER DATED OCT. 7, 1993).

15. CORPORATION WAS NOT A MEMBER OF THE TAXPAYER UNITARY GROUP, AND THE STATE DID NOT PROPOSE TO TAX CORPORATION'S INCOME. (NOTICE OF DEFICIENCY; IL-1120).

CONCLUSIONS OF LAW:

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BUSINESS INCOME OF A NON-RESIDENT TAXPAYER IS APPORTIONED TO THE STATE OF ILLINOIS BY MEANS OF A THREE-FACTOR FORMULA. 35 ILCS 5/304(A). UNDER ILLINOIS LAW, NON-BUSINESS INTEREST INCOME IS ALLOCABLE TO ILLINOIS IF IT IS THE STATE OF COMMERCIAL DOMICILE. 35 ILCS 5/301(C)(2)(B).

TAXPAYER ARGUES THAT THE INTEREST FROM ITS TAX-EXEMPT SECURITIES IS NON-BUSINESS INCOME AND SHOULD BE ALLOCATED TO ITS COMMERCIAL DOMICILE, AND THEREFORE IS NOT SUBJECT TO TAX IN ILLINOIS.

SECTION 1501(A)(13) DEFINES NONBUSINESS INCOME AS "ALL INCOME OTHER THAN BUSINESS INCOME." 35 ILCS 5/1501(A)(13). BUSINESS INCOME IS DEFINED AT 35 ILCS 5/1501(A)(1) AS:

INCOME ARISING FROM TRANSACTIONS AND ACTIVITY IN THE REGULAR COURSE OF THE TAXPAYER'S TRADE OR BUSINESS, NET OF THE DEDUCTIONS ALLOCABLE THERETO, AND INCLUDES INCOME FROM TANGIBLE AND INTANGIBLE PROPERTY IF THE ACQUISITION, MANAGEMENT, AND DISPOSITION OF THE PROPERTY CONSTITUTE INTEGRAL PARTS OF THE TAXPAYER'S REGULAR TRADE OR BUSINESS OPERATIONS.

FURTHERMORE, THE DEPARTMENT'S REGULATIONS PROVIDE:

A PERSON'S INCOME IS BUSINESS INCOME UNLESS CLEARLY CLASSIFIABLE AS NONBUSINESS INCOME...INCOME OF ANY TYPE OR CLASS AND FROM ANY SOURCE IS BUSINESS INCOME IF IT ARISES FROM TRANSACTIONS AND ACTIVITY OCCURRING IN THE REGULAR COURSE OF TRADE OR BUSINESS OPERATIONS. ACCORDINGLY, THE CRITICAL ELEMENT IN DETERMINING WHETHER INCOME IS "BUSINESS INCOME" OR "NONBUSINESS INCOME" IS THE IDENTIFICATION OF THE TRANSACTIONS AND ACTIVITY WHICH ARE THE ELEMENTS OF A PARTICULAR TRADE OR BUSINESS. IN GENERAL, ALL TRANSACTIONS AND ACTIVITY WHICH ARE DEPENDENT UPON OR CONTRIBUTE TO THE OPERATIONS OF THE ECONOMIC ENTERPRISE AS A WHOLE WILL BE TRANSACTIONS AND ACTIVITY ARISING IN THE REGULAR COURSE OF A TRADE OR BUSINESS.

§6 ADMIN. CODE CH. I, SEC. 100.3010(A).¹

REGARDING INTEREST INCOME, THE REGULATIONS SPECIFICALLY STATE:

INTEREST INCOME IS BUSINESS INCOME WHERE THE INTANGIBLE WITH RESPECT TO WHICH THE INTEREST WAS RECEIVED, IS HELD OR WAS CREATED IN THE REGULAR COURSE OF THE PERSON'S TRADE OR BUSINESS OPERATIONS OR WHERE THE PURPOSE FOR ACQUIRING OR HOLDING THE INTANGIBLE IS RELATED OR ATTENDANT TO SUCH TRADE OR BUSINESS OPERATIONS.

§6 ADMIN. CODE CH. I, SEC. 100.3010(D)(4).

EXAMPLE E PROVIDED IN THE ABOVE REGULATION DIRECTLY ADDRESSES THE FACT SITUATION AT HAND:

A CORPORATION IS ENGAGED IN A MULTISTATE MANUFACTURING AND SELLING BUSINESS. THE CORPORATION USUALLY HAS WORKING CAPITAL AND EXTRA CASH TOTTALLING \$200,000 WHICH IT REGULARLY INVESTS IN SHORT-TERM INTEREST BEARING SECURITIES. THE INTEREST INCOME IS BUSINESS INCOME.

§6 ADMIN. CODE CH. I, SEC. 100.3010(D)(4)(E).

IN ADDITION, CASE LAW HAS ESTABLISHED TWO TESTS TO DETERMINE WHETHER INCOME IS BUSINESS INCOME: THE TRANSACTIONAL TEST AND THE FUNCTIONAL TEST. DOVER CORP. V. DEPT. OF REVENUE, 271 ILL. APP. 3D 700, 648 N.E.2D 1089 (1ST DIST. 1995); NATIONAL REALTY & INVESTMENT CO. V. DEPT. OF REVENUE, 144 ILL. APP. 3D 541, 494 N.E.2D 924 (2ND DIST. 1986). IF EITHER TEST IS MET THE INCOME IS BUSINESS INCOME.

THE TRANSACTIONAL TEST DERIVES FROM THE FIRST CLAUSE OF SECTION 1501(A)(1). INCOME IS CLASSIFIED AS BUSINESS INCOME IF IT IS DERIVED FROM A TYPE OF BUSINESS TRANSACTION IN WHICH THE TAXPAYER REGULARLY ENGAGES. THE FUNCTIONAL TEST IS DERIVED FROM THE SECOND CLAUSE OF SECTION 1501(A)(1). UNDER THE FUNCTIONAL TEST, THE RELEVANT INQUIRY IS WHETHER THE PROPERTY WAS USED IN THE TAXPAYER'S REGULAR TRADE OR BUSINESS OPERATIONS.

¹ Formerly Section 100.3050(a).

TAXPAYER BEARS THE BURDEN OF DEMONSTRATING THAT A GIVEN ITEM OF INCOME IS NOT BUSINESS INCOME. TAXPAYER HAS PRESENTED NO EVIDENCE THAT THESE INVESTMENTS DID NOT ARISE IN THE REGULAR CONDUCT OF ITS TRADE OR BUSINESS. SINCE TAXPAYER HAS PRODUCED NO EVIDENCE AS TO HOW THE SECURITIES FROM WHICH THE INTEREST INCOME AROSE WERE ACQUIRED, IT IS NOT UNREASONABLE TO PRESUME THAT THE SECURITIES WERE ACQUIRED WITH FUNDS PRODUCED FROM TAXPAYER'S REGULAR BUSINESS ACTIVITIES. SO LONG AS THE SECURITIES RESULT FROM THE REGULAR TRADE OR BUSINESS OF THE COMPANY, THEN, THE INTEREST INCOME DERIVED FROM THOSE SECURITIES IS BUSINESS INCOME UNDER THE TRANSACTIONAL TEST.

FURTHERMORE, WHILE TAXPAYER ASSERTS THAT THESE INVESTMENTS SHOULD BE TREATED AS NONBUSINESS INCOME SINCE THEY WERE "EXCESS FUNDS," TAXPAYER HAS PRESENTED NO EVIDENCE AS TO HOW THE MONIES WERE USED OR THAT THERE WERE ANY SIGNIFICANT RESTRICTIONS PLACED ON THEIR USE. TO THE CONTRARY, WHAT IS PART OF THIS RECORD IS TAXPAYER'S ACKNOWLEDGMENT THAT "TAXPAYER MAINTAINED IN ITS INVESTMENT ACCOUNTS SUFFICIENT FUNDS TO FINANCE THE NEEDS OF THE BUSINESS." (TAXPAYER'S LETTER OF OCTOBER 7, 1993). IT IS REASONABLE TO ASSUME THAT THIS STATEMENT EVIDENCES THE FACT THAT ALL OF THE MONIES IN THE ACCOUNTS WERE USED FOR BUSINESS PURPOSES. IF THESE MONIES WERE USED IN TAXPAYER'S REGULAR TRADE OR BUSINESS OPERATIONS, THEN THE FUNCTIONAL TEST FOR BUSINESS INCOME HAS BEEN MET AS WELL.

IN CHAMPION INTERNATIONAL CORP. V. BUREAU OF REVENUE, 540 P.2D 1300 (N.M. APP. 1975), THE TAXPAYER ALSO CLAIMED THAT INTEREST ON CERTAIN INVESTMENTS WAS NONBUSINESS INCOME SINCE CHAMPION WAS NOT IN THE BUSINESS OF MAKING INVESTMENTS. THE COURT DISAGREED WITH THE TAXPAYER AND HELD THAT SINCE THIS WAS A NORMAL AND CUSTOMARY PRACTICE OF CHAMPION TO INVEST ITS EXCESS CAPITAL, THE INTEREST INCOME EARNED ON EXCESS CAPITAL WAS BUSINESS INCOME.

SIMILARLY, THE GENERAL LEDGER DETAIL PROVIDED BY TAXPAYER SHOWS EXTENSIVE ACTIVITY IN ACCOUNTS 1161, 1164, 1165, AND 1170. MONEY WAS TRANSFERRED IN AND OUT OF THESE ACCOUNTS ON A FREQUENT BASIS. LOOKING AT THE INVESTMENT ACTIVITY IN THE TAX-EXEMPT ACCOUNTS, THE TOTAL AMOUNT INVESTED DROPPED FROM \$108 MILLION AT JANUARY 31 TO \$78 MILLION AT JUNE 30. TAXPAYER, THEREFORE, WITHDREW \$30 MILLION OF THESE FUNDS FOR ITS USE DURING THIS FIVE-MONTH PERIOD.

ALTHOUGH TAXPAYER AVERS THAT THIS MONEY IS NOT USED AS WORKING CAPITAL, THE EVIDENCE OF RECORD IS TO THE CONTRARY. NOT ONLY DOES THE TAXPAYER ADMIT USING THE FUNDS FOR BUSINESS PURPOSES, BUT THERE IS NO EVIDENCE THAT RESTRICTIONS WERE PLACED ON THE USE OF THE FUNDS. SINCE

NO RESTRICTIONS WERE PLACED ON THE USE OF THE FUNDS, TAXPAYER COULD USE THESE MONIES TO DEVELOP NEW PRODUCTS, PURCHASE PLANT ASSETS, PAY DIVIDENDS OR ANY OTHER USE IN KEEPING WITH ITS TRADE OR BUSINESS. THE FACT THAT TAXPAYER WAS ABLE TO ACCESS THESE FUNDS FOR USE IN ACTIVITIES RELATED TO ITS TRADE OR BUSINESS ONLY SUPPORTS FURTHER THE DEPARTMENT'S POSITION THAT THE INCOME EARNED FROM THESE INVESTMENTS MUST BE CLASSIFIED AS BUSINESS INCOME.

TAXPAYER HAS ALSO OFFERED AS EVIDENCE THAT \$75 MILLION WAS WITHDRAWN TO FUND A NEW SUBSIDIARY, CORPORATION, WHOSE ONLY FUNCTION WAS TO MANAGE THE INVESTMENT OF THE FUNDS. FOR THE LAST FOUR MONTHS OF THE TAX YEAR ENDED NOVEMBER 30, 1989, CORPORATION MANAGED \$75 MILLION OF THE INVESTMENTS (\$15 TO \$25 MILLION REMAINED IN TAXPAYER) AND NO WITHDRAWALS WERE MADE BY TAXPAYER.

THE INTEREST INCOME AT ISSUE IN THIS CASE, HOWEVER, WAS EARNED BY TAXPAYER ON ITS OWN INVESTMENTS, NOT BY CORPORATION'S INVESTMENTS. CORPORATION WAS NOT DETERMINED TO BE UNITARY WITH TAXPAYER DURING THIS PERIOD AND WAS NOT SUBJECT TO ILLINOIS TAX. CORPORATION'S ACTIVITIES, THEREFORE, ARE NOT RELEVANT. ALL OF THE FUNDS WHICH GENERATED THE INTEREST AT ISSUE WERE TAXPAYER'S ALONE AND WERE AVAILABLE TO TAXPAYER'S UNRESTRICTED USE.

SINCE THESE INVESTMENTS AROSE FROM THE NORMAL COURSE OF TAXPAYER'S BUSINESS, AND TAXPAYER WAS ABLE TO PUT THESE MONIES TO USE FOR WHATEVER BUSINESS PURPOSE IT DEEMED APPROPRIATE, THE INTEREST EARNED THEREON MUST BE CONSIDERED TO BE BUSINESS INCOME.

IN CONCLUSION, TAXPAYER HAS FAILED TO INTRODUCE SUFFICIENT EVIDENCE TO REBUT THE PRIMA FACIE CORRECTNESS OF THE DEPARTMENT'S PROPOSED ASSESSMENT.

ISSUE #2

TAXPAYER GENERALLY PROTESTED THE IMPOSITION OF THE TAX, INTEREST AND PENALTIES RELATING TO THE DISALLOWANCE OF THE TREATMENT OF THE INTEREST EARNED ON ITS TAX-EXEMPT SECURITIES AS NONBUSINESS INCOME. IT IS UNCLEAR WHETHER TAXPAYER'S PROTEST IS SUFFICIENT TO REQUEST ABATEMENT OF THE SECTION 1005 PENALTY. HOWEVER, SINCE THERE IS SOME EVIDENCE IN THE RECORD WHICH GOES TO WHETHER TAXPAYER'S ACTIONS WERE REASONABLE, I WILL CONSIDER THE SECTION 1005 ISSUE.

TAXPAYER MAINTAINS THAT ITS RETURN POSITION WAS TAKEN DUE TO THEIR BELIEF THAT THE FACTS IN REGULATIONS SECTIONS 100.3010(D)(2)(D) AND (5)(F)² WERE SIMILAR TO THEIR FACTS. ON THE CONTRARY, THE EXAMPLE AT (2)(D) INVOLVES RENTAL PROPERTY UNRELATED TO THE TRADE OR BUSINESS OF THE TAXPAYER, AND THE EXAMPLE AT (5)(F) INVOLVES STOCK AND INTEREST-BEARING SECURITIES WHICH ARE UNRELATED TO THE CORPORATION'S TRADE OR BUSINESS OPERATIONS. TAXPAYER HAS ADMITTED THAT IT MAINTAINS SUFFICIENT FUNDS IN ITS INVESTMENT ACCOUNTS TO FINANCE THE NEEDS OF THE BUSINESS, SO THAT TAXPAYER CANNOT CLAIM THESE INVESTMENTS ARE UNRELATED TO ITS TRADE OR BUSINESS. NEITHER REGULATION SECTION APPLIES TO TAXPAYER'S SITUATION. IN FACT, TAXPAYER HAS APPARENTLY IGNORED REGULATION SECTION 100.3010(D)(4)(E) WHICH IS DIRECTLY ON POINT. THEREFORE, I FIND THAT TAXPAYER DID NOT SHOW REASONABLE CAUSE FOR ITS UNDERPAYMENT OF TAX, SO THAT THE SECTION 1005 PENALTY STANDS.

WHEREFORE, FOR THE REASONS STATED ABOVE, IT IS MY RECOMMENDATION THAT THE NOTICE OF DEFICIENCY SHOULD BE FINALIZED IN ITS ENTIRETY.

DATE:

LINDA K. CLIFFEL
ADMINISTRATIVE LAW JUDGE

² Formerly Sections 100.3050(d)(2)(D) and (5)(F).